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STATE PASS USTDA FOR AMCKINNEY
STATE PASS OPIC FOR DEMROSE, NRIVERA, CMERVENNE
NSC FOR TOMASULO
TREASURY FOR JHOEK
USDOC FOR 4332/ITA/MAC/WH/OLAC
USDOC ALSO FOR 3134/USFCS

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TAGS: EFIN ECON EINV BR
SUBJECT: BRAZIL: INVESTMENT GRADE BY 2008?

Summary

¶1. (U) Amid public speculation surrounding Brazil's possible ascent to an investment grade bond rating, Econoffs visited the credit ratings agencies Standard and Poors (S&P) and Moody's to solicit their views. Both ratings agencies have divergent opinions about the quality of Brazil's fiscal accounts and thus differ on when they see a potential move to investment grade for the country. S&P believes the increase in Brazil's public sector spending is controlled, while Moody's remains concerned that the spending on domestic programs is too high. The decision to upgrade is, therefore, far from certain, and as Brazil lags behind other investment grade countries especially in its relatively high external debt burden, the ratings agencies appear to be proceeding cautiously. Ultimately, Brazil must convince the ratings agencies that Brazilian investments are stable and secure before they are willing to risk their reputations. Both agencies agree that even if Brazil obtains an investment grade credit rating, the benefits likely would be minimal because investors already consider many Brazilian assets investment grade. End Summary.

Considerable Divergence Among Ratings Agencies

¶2. (U) Credit ratings agencies Moody's and Standard and Poor's (S&P) presented two different views of Brazil's progress toward achieving an investment grade sovereign bond rating in recent meetings with Econoffs. S&P Managing Director for Brazil, Regina Nunes said that the rating agencies are less consistent in Brazil than in any other country with S&P having moved Brazil to one step below investment grade significantly earlier than Moody's when they made the move back in March of this year. Only on August 20 did Moody's upgrade Brazil's foreign currency sovereign bond rating to

investment grade and the local currency rating to one notch below investment grade with the overall rating remaining one notch below investment grade. S&P, on the other hand, looks more favorably on local currency bonds, which are investment grade, than on foreign currency bonds, at one step below.

¶3. (U) Luiz Tess, Representative Director for Moody's Latin America told Econoffs that Brazil's fiscal performance indicators do not meet the standards of other investment grade countries. In reviewing Brazil's spending patterns over the long term and in light of past trends, Moody's sees a troubling trend in increased government spending. Tess pointed to 26,000 new public sector jobs and increased spending of more than $3 billion USD planned for next year. In order for Moody's to have a positive outlook, Brazil needs to show that interest rates, its debt profile, and other fiscal indicators are declining. [Note: This more cautious view of Brazil's chances of obtaining the investment grade rating was called into question when Moody's Investor Services Vice-President recently told Brazilian press that Brazil is very close to obtaining investment grade. End Note.)

¶4. (U) S&P painted a more positive picture of the Brazilian fiscal sector. Nunes told Econoffs that S&P believes the Brazilian government is spending more than last year, but not above what the government budgeted for the year, and therefore S&P has already built it into their models. Furthermore, she acknowledged that Brazil spends a lot, but noted the capability of payment and the quality of spending determines Brazil's future ability to pay, and Brazil also is capable of financing itself domestically. (Note: 91 percent of Brazil's public debt is domestic. End Note.) She also highlighted that qualitative spending is more important for Brazil than quantitative spending targets, and in Brazil's case, simply cutting spending could do more damage than good.

¶5. (U) Mauricio Oreng, Vice President of Economic Research at Banco Itau, Brazil's second largest bank, sees no problems in the external sector but agreed with Moody's that the fiscal sector is problematic. He told Econoffs that foreign reserves are at an historic high, external debt is declining, and the GoB is maintaining the primary surplus at 4.5 percent of GDP, a figure that the GoB would be unable to reduce due to delays in implementing infrastructure and government expenditure projects. He believes fiscal policy previously was the Achilles heel to getting investment grade, but does see an improvement there as well.

Debt Burden an Obstacle

¶6. (U) Financial analysts often cite Brazil's net debt burden as one of the primary arguments against classifying Brazil as investment grade. Both S&P and Moody's noted that other investment grade countries have much lower debt to GDP ratios than Brazil's 44 percent. Even Mexico's debt to GDP ratio, considered high among investment grade countries, is about 30 percent, but has the important advantage of the proximity to the US market. Brazil's over $160 billion USD in foreign reserves demonstrate its ability to repay, however potential repayment does not mean Brazil would actually repay or that creditors would accept prepayment of Brazil's debt. Nunes did note, however, that S&P was more concerned about Brazil's debt profile two years ago than today, despite higher spending, because Brazil has brought its net debt to GDP ratio down from 56 percent in 2002.

Investment Grade Not the Silver Bullet but a Big Advantage

¶7. (U) Brazil is unlikely to see any major improvements if the ratings agencies upgrade its sovereign rating to investment grade, but there are considerable benefits on the margins. A sovereign rating usually serves as a credit ceiling for companies and government alike, and an upgrade to investment grade would immediately raise the credit worthiness of those companies and government agencies impeded by the country's overall credit rating.

¶8. (U) Ratings agencies have already designated several Brazilian companies and banks investment grade. Furthermore, Tess told Econoffs that the market already has calculated the upgrade into asset prices. An upgrade would, however, open up the possibility for institutional investors to buy Brazilian assets that are otherwise restricted to investment grade assets. It also would help improve Brazil's debt profile by extending debt maturities and reducing the spreads between Brazilian bonds and U.S. Treasury Bills. (Note: Nearly one third of Brazil's public sector debt matures in less than three years. End Note.) Lower borrowing costs also would free up cash for investments.

Split Rates Problematic

¶9. (U) Two of the three ratings agencies already assign different credit ratings to local and foreign currency bonds, but consistent local and foreign currency bond ratings of investment grade are normally required for investors to consider a country investment grade. The likely scenario in which only one of the two primary agencies (S&P and Moody's) upgrades Brazil also complicates the immediate benefits that Brazil would receive. Some institutional investors are prohibited from buying assets if both agencies do not agree, and Brazil would have to wait for the other to upgrade before enjoying any positive advantage from the rating.

Investment Grade by Next Year?

¶10. (U) The big question that everyone is trying to predict is whether Brazil will achieve investment grade by next year. Oreng told Econoffs Brazil should have investment grade by the end of
¶2008. Nunes believes investment grade will come if Brazil's economy follows the status quo, but acknowledged that investment grade is not a slam-dunk yet. S&P has given Brazil seven positive actions on the sovereign rating since 2002, and maintains a positive outlook over the next 18 months. Brazil has beaten targets every month so far, but Nunes expressed concern that Brazil could have problems if liquidity and worldwide growth decline. Tess said Moody's does not see investment grade in the near term unless the GoB exhibits more fiscal discipline and reduces debt levels.

¶11. (U) Credit ratings measure the level of risk within a country relative to other countries and the timing depends on the relative performance of other investment grade countries. Brazil's foreign reserves are impressive, but not as high as other investment grade countries. Russia, for example, has three times its debt in reserves, while Brazil's reserves barely cover net debt. Nunes noted it took S&P seven years to rate Mexico investment grade and six years each for South Africa and Spain. Statistically speaking, she said S&P upgraded 36 percent of countries previously one notch below investment grade within two years, 17.3 percent in three years, and another 22 percent in five years.

Comment

¶12. (U) Despite ratings agencies' and investment analysts' public pronouncements that investment grade is inevitable, the jury is still out whether Brazil will receive the coveted investment grade credit rating before the end of 2008. Brazil's economic performance, however, continues to outpace expectations, so an upgrade could come sooner than expected. The jump to investment grade is harder than other upgrades and ratings agencies' credibility rests in their ability to minimize investment risk. Brazil still needs to demonstrate that its economic performance, (currently anemic in comparison to similar developing economies), and fiscal policies are such that the odds of a reversal on the sovereign rating are minimal. Only then will the agencies believe Brazil is a consistent investment grade option and grant the country the coveted investment grade rating. End Comment.

¶13. (U) This cable was coordinated with the Treasury Attache and

Embassy Brasilia.

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